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THE FOUNDATIONS OF MULTISTAKEHOLDING: THE PROBLEM OF THE COSTS OF EXCLUSION

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Abstract.

Henry Hansmann has argued that ownership is best allocated to the group of patrons for which the total of cost of governance and contracting for all the firm's patrons combined is minimized. This paper re-founds Hansmann's model by considering an additional set of costs, the costs of excluding certain groups of patrons from the firm's decision-making or governance process. The objective, which is Coasean in both spirit and formulation, is to show (1) that firms with “multi-stakeholder governance” emerge to economize on exclusion costs, and (2) that the efficient governance structure minimizes the total cost of membership, contracting and exclusion costs for all the firm's patrons combined. The paper argues that this setup helps explain so-called “public organisation,” defined as organisations with public interest objectives, and further claims that this model helps explaining the recent emergence of multi-stakeholder enterprises within the third sector.

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JEL: L2, L3, H4, O35

In devising and choosing between social arrangements we should have regard for the total effect. This, above all, is the change in approach that I am advocating.

(Coase, 1960, p. 44)

1. Introduction

Henry Hansmann has argued that ownership is best allocated to the group of patrons for which the total of cost of governance and contracting for all the firm's patrons combined is minimised. This paper re-founds Hansmann's model by considering an additional set of costs, the costs of excluding certain groups of patrons from the firm's decision-making or governance process.

The objective, which is Coasean in both spirit and formulation, is to show (1) that firms with "multi-stakeholder governance" emerge to economize on exclusion costs, and (2) that the efficient governance structure minimizes the sum of cost of membership, contracting and exclusion for all the firm's patrons combined. This setup helps explain what can be called "public organisations," defined as organisations with public interest objectives, and further claims that this model helps explaining the recent emergence of multi-stakeholder enterprises.

The theoretical framework is set up by Hansmann's model. Hansmann (1996) focuses on the costs of ownership. He thinks that the most efficient form of ownership occurs when a firm is governed by 'the class of patrons for whom the costs of market contracting are highest' and 'the costs of ownership are lowest' (1996, p. 47). More generally, his calculus indicates that in order to reach

efficiency, governance must minimise total costs or the sum, over all the firm patrons, of costs of contracting (CC) and costs of ownership (CO).

$$CO_j + \sum_{i=1}^{n-1} CC_i$$

In this way, ownership economises on transaction costs by avoiding market contracting for whichever “patron” is assigned control rights. If it were not for CO, it would follow that all patrons should be assigned control rights to minimise costs.

Even in the presence of CO, however, there is no a priori to believe that such costs are less than CC for only one class of patrons – this could be the case for multiple patrons, and perhaps even all patrons. Hansmann (1996, p. 44) actually points this out in his book in the sub-section entitled ‘Why Not Make Everybody an Owner?’, but maintains that CO would multiply if multiple groups were involved due to their diversity and heterogeneity of interests. He suggests that control over decision-making should be given to one type of stakeholder, specifically the one whose interests are less safeguarded by a contract with respect to other interest holders, provided that CO are kept at reasonable levels. This would happen, for example, if clients (e.g. patients in healthcare; debtors and creditors in banking, etc.) did not want to be directed by investors’ interests and recognised the advantage of self-directing themselves, according to their own interests. Inclusion of the most vulnerable public (*vis a vis* ‘investors’ in this case)

is the solution to contract incompleteness, information asymmetries and ultimately a response to the possibility that investors pass the risk of enterprise onto users or clients. This criterion allows to minimise conflict and therefore total costs.

The problem we identify with substituting market with organised transactions under the control of one single category of patrons is in the assumption. It is anticipated in fact that there is only one market that does not coordinate resources efficiently. However, the reality of production and consumption is more complex than this. When multiple and potentially conflicting interests are at stake and transaction costs are present, nor market contracting, nor the single entrepreneur or decision-maker representing one class of interests can avoid to produce negative (intended or unintended) effects on the excluded patrons and on society more broadly, unless there is a way to broaden the scope of decision-making.

This interpretation is supported by the specific view on externalities proposed by Meade (1973). He defined externalities as ‘an event which confers an appreciable benefit (inflicts an appreciable damage) on some person or persons who were not fully consenting parties in reaching the decision or decisions which led directly or indirectly to the event in question’ (quoted in Cornes and Sandler, 1999: 39). Interestingly, Meade relates the occurrence of externalities to the exclusion of interested actors from the decisions that led to the external effect. Another peculiarity of this definition is that it does not refer to any specific context or

institutional solution (Cornes and Sandler, 1999). Therefore, this interpretation of externalities explains their existence by pointing at the exclusion of patrons and their interests, rather than to the absence of a specific coordination structure, such as markets and underpinning property rights. In addition, Meade's definition leaves the option open for multiple markets to fail at the same time; or not to fail at all, but in fact changing the distribution of income when decision-makers alter trading prices also for other patrons. The latter exemplifies what Meade calls a 'distributive externality'.

Differently from Meade's interpretation, externalities are commonly understood as 'uncompensated interdependencies' in the context of competitive markets. The solution proposed by economic theory is to define the external effects as a good or a disutility that can be traded. It is then necessary to define who has property rights on the good to be exchanged, that is who can claim a monetary compensation or derive income from excluding others from exchange (cf. Alt and Shepsle, 1990). Thus, costs of exclusion are understood as the costs maintained to exclude others from the use of resources. They are, in other words, *transaction costs borne by the owner of property rights*.

Differently, in this work, exclusion costs are meant as the costs borne by the excluded. They are *externalities borne by the non-owners*. Our argument is that the specification of property rights to be traded on the market addresses only one type of exclusion cost, e.g. those that can be compensated for a price without

causing the persistence of the externality. For exclusion costs that cannot be equated with a good and traded on the market, different institutional solutions are required.

While economic theory has explained why including patrons can be costly, it is less clear why so little attention has been devoted to the fact that excluding patrons can also be costly. The paper's model introduces exclusion costs in the economic calculus used to identify production governance, which typically includes costs of transacting and costs of ownership. Rather than associating exclusion costs with property rights to be compensated ex-post, the model identifies the coordination solution that minimises their emergence ex-ante, as well as total governance costs.

In shedding light on the inclusion of multiple patrons, the model sets the premises to define what can be called the 'public organisation'. Clearly here the word 'public' is not used in the traditional sense of being owned by the public authority. It is rather understood in the sense of having multiple patrons and pursuing a plurality of interests by means of collective action and consistently with principles of social justice. Building on transaction cost theory (Williamson, 1997), the paper's model indicates that the public organisation will include patrons:

- i. The higher the costs of exclusion, or the highest the costs of relying on market transactions

- ii. The highest the value of continuity in transactions
- iii. The less the rise of the cost of organising as one more patron is included, and the slower the speed of the rise.

Bridging theory with practice, the model also helps explain the emergence of what are increasingly identified as multi-stakeholder enterprises in welfare sectors. It also contributes to the policy debate around the creation of more inclusive economies, under the so-called ‘inclusive capitalism’ agenda promoted by the former US Treasury Secretary Lawrence Summers, which recently featured also in a Governor of the Bank of England’s speech (Carney, 2014).

The structure of the paper is as follows. Section 2 complements this introductory Section with a discussion of Hansmann’s model. Section 3 discusses the problem of extending membership to multiple patrons. Section 4 presents a new model which includes exclusion costs. Section 5 discusses the new model in terms of supporting institutional solutions. Section 6 concludes.

2. Discussion of Hansmann’s model

There are some critical points in Hansmann’s model which require attention. In this Section the paper problematises elements which are not consistent with patrons’ participation in decisions of interest, and therefore enable the persistence of exclusion costs as per Meade’s definition of externalities. As summarised in the introduction, in Hansmann’s model exclusion costs are resolved with

contracts. The assumption that underpins the imperative of single stakeholder control is that this solution maximises efficiency since CO for the controlling patron is lower than the sum of the costs of trading with all the remaining patrons. Occasionally, however, Hansmann notices that “enfranchising” a patron requires that another is “disenfranchised”, and that yet another patron is denied franchise (Hansmann, 1996, p. 43). The disenfranchised, in Hansmann’s calculus, are all the organisation’s patrons linked to the controlling patron (who bears CO) by means of transactions (which generate total CCI). For example, a single-stakeholder, investor-owned organisation is justified by high levels of transaction costs affecting investors. Because of this, investors would be “enfranchised,” whilst other patrons (e.g. consumers, workers, volunteers, creditors) would be disenfranchised. With all the disenfranchised patrons, the investor would set contracts since markets work with lower transaction costs and, overall, market relations are assumed to protect disenfranchised patrons using well-defined contracts. Other patrons, at the same time, are denied any form of association with the controlling patrons. For example community constituencies would not be involved neither through ownership, nor through contracts.

The first point to be noticed is that Hansmann’s model does not consider that multiple markets can fail at the same time (for example the market for capital, for labour, for finance, for goods). The interests of the disenfranchised are safeguarded via the contractual system, assuming that markets are competitive

and contract law is well defined. However, for the “not consenting” patrons, restricting control to one single patron would generate high costs of exclusion, which are not captured by contractual solutions. In fact improving the efficiency for one patron only, whilst disenfranchising or denying any form of association to other patrons cannot be argued to be, overall, a Pareto-improvement.

For other transacting patrons markets keep failing. Because contractual solutions address some elements of inclusion and not others, most of the sources of market failure that Hansmann identifies (footnote) persist for excluded patrons. For example, information asymmetries (e.g. in medical or educational services) and lock-in situations (for example in energy markets or financial services) imply higher prices, lower quality, or the unethical employment of users’ resources, (e.g. users’ personal information; clients savings) to extract extra profits.

Consider school governance. The allocation of resources amongst activities (such as playgrounds, support to disadvantaged pupils, or additional afternoon tutorials) can be done by the head of school depending on the public funding available and reporting to a controlling authority. In this case the prevailing cost of exclusion would be the excessive standardisation of services, and a complete dependence on public sector’s budget allocation to schooling for improvements. At the opposite extreme, private schools would use the market, by asking families to pay fees for accessing additional infrastructures and service improvement. Here the prevailing exclusion cost regards pricing under information asymmetries and

access, which would be denied to those who are not able to pay, albeit education can be regarded as a merit good. Differently, in community-run schools, allocation would be done in principle by a board of trustees including multiple community constituencies, with links to local authority but more independent from state funds than conventional institutions.¹ Such a solution could be argued to mitigate the exclusion costs generated by the other alternatives.

The fact that patrons cannot bring into the debate their interests, knowledge and experience also creates broad exclusion costs in terms under-consumption. This is due to mark-up on service prices, or to choices about the nature of products or solutions that become generally available to society. There are various reasons for this. Exclusion denies diversity, generating costs in terms of inappropriate problem framing, lower use of creativity, and a more modest match between the innovations introduced and societal needs.

In addition, exclusion erodes an array of non-material benefits which cannot be subject to property right definition or subsumed by a contract. Evidence indicates that excluded patrons benefit only in a marginal way from the learning and relational experience that derives from taking part in activities (Sacchetti and Tortia, 2013). Exclusion, moreover, has been identified as one of the causes that

¹ In the UK, cooperative schools are called “independent state-schools”. They have been growing since the Education and Inspection Act of 2006.

reduces psychological satisfaction, by impoverishing individuals' sense of belonging, accomplishment and overall wellbeing (Deci and Ryan, 2008).

Another reason is the failure to generate social capital. Woolcock (2001, 13) suggests that 'social capital refers to the norms and networks that facilitate collective action'. Such norms have been associated with cooperation, trust, and reciprocity of behaviours. In this sense, exclusion prevents the development of these norms and ties' leading to lack of collective action more broadly (Aoki, 1984; Ostrom 2010; Borzaga and Tortia, 2015; Fitzroy and Kraft, 1986; Lopes et al. 2009; Putterman, 1984; Thomson, 2015).

Another disadvantage is related to resource allocation. Because exclusion denies the right to voice, patrons will be less keen to input resources. For example in non-profit firms (but the same could be said for the public sector) exclusion may engender less voluntary work, erosion of pro-social motivations, membership fees, donations which would otherwise be deployed in other situations. On the contrary, inclusion facilitates recovering resources that the organisation can then apply to develop activities in support of the needs identified by participated governing bodies.

These limitations emerges in Hansmann's treatment of non-profits. He acknowledges that non-profits may prevail when the costs of both ownership and contracting are exceptionally high for a given class of patrons (usually donors/users). On the one hand, giving ownership to any other class of patrons

would ‘inefficiently threaten those patrons’ interests’. Nonetheless, giving ownership to the weakest class would incur very high CO, since the non-profit structure incurs costs of its own in the form of the managerial agency problem (Hansmann, 1996, pp. 48-49). Notably, this logic is inconsistent with his usual calculus of comparing the costs of contracting with those of ownership. As a solution he suggests that non-profits should have no owners, and be controlled by a board of trustees.

It therefore seems that even his analysis of non-profits confirms that the calculus is based on some missing type of cost that he does not explicitly identify, related to the absolute CC as opposed to just their comparison with CO. What Hansmann suggests is that, even if it is not efficient to make a certain class of patrons owners, excluding them from governance would incur such a high level of costs (unspecified) beyond information asymmetries for it to be undesirable (what Hansmann dubiously refers to as ‘inefficiently threatening their interests’). The point here relates not only to non-profits but to all types of firms, since Hansmann in fact states that ‘the distinction between non-profit firms and firms owned by patrons who are very poor monitors is often negligible’ (Hansmann, 1996, p. 49) and goes on to show how this is true for all forms of enterprise (e.g. worker cooperative, user cooperative, investor-owned firm, albeit he acknowledges that this latter typology can be equivalent to a cooperative of investors).

3. Responses to coordination failure

The inadequacy of the model to explain how to protect multiple interests at the same time is that it does not consider exclusion costs generated by single-stakeholding, mostly because it relies on the well-functioning contracts. Rather, the inclusion of patrons with diverse features requires a variety of institutional solutions. Ownership represents one solution, but it can be complemented by other forms of representation in decision-making bodies which are aimed at requesting (and enabling) managers to justify their actions in front of multiple patrons. The requirement would enable managers to take into account a wider set of interests, beyond those of owners, when making strategic decisions.

As an illustration, consider a hospital and community care clinics owned by investors, who in Hansmann's terms, are good monitors and homogeneous enough to bear low CO. The members decide to centralise diabetes community services within the hospital in order to take advantage of scale economies. This implies a closure of local diabetes clinics. Despite the costs of exclusion engendered for specific patrons and the collectivity, it would be hard for managers to reject this strategy if they owed a fiduciary duty exclusively to investors. However, if the duty of loyalty is broadly understood to apply to a wider set of patrons, i.e. patients in general, and specific classes of patients such as elderly people and people with reduced mobility, it would be possible for health managers to reject the indication to centralise services on the grounds that there are vulnerable members and society at large who would suffer from

centralisation and increasingly so given demographic trends. Losses for the weakest classes of patrons (e.g. worsening of health conditions) and for society (e.g. in terms of under-consumption of preventive care, hospitalisation or increased marginalisation of the elderly, for instance) would outweigh the gains for investors. With multi-stakeholder governance, managers would not be able to support and justify actions to preserve their position whilst, at the same time, disregard the interest of vulnerable patrons. Extending representation and, therefore, managers' fiduciary duty, would have the effect of reducing the production of exclusion costs.

4. A “total effect” governance model

The persistence of exclusion costs suggests that, overall, it is simplistic to ignore them on the basis that they are irrelevant, as Hansmann's model seems to suggest. The model presented here, instead, requires to account for the overall costs of governance, rather than being confined to ownership and contracts. In this Section, we re-found Hansmann's model to include exclusion costs and ground a new way of appraising governance solutions.

An organisation that takes into account multiple interests is referred to as a ‘public organisation’, as defined in the introduction, as representing multiple patrons and pursuing a plurality of interests consistently with principles of social justice. Such an organisation will grow if additional publics and their interests are coordinated

through the organisation, and becomes smaller as the firm abandons the organisation of these interests.

The question then would be: when does the organisation stop including patrons? Given a number of patrons, N , who are interconnected with the organisation (directly or indirectly, informally or on a contractual basis), the inclusion of publics (PI) minimises a function that includes membership costs (CM), contractual costs (CC), and the costs of exclusion (CE). CM include both CO and costs of governing without ownership. The choice of whether to include new publics (PI) needs considering CM, CC and CE together. According to the model, new publics are included if $CE > CM$. The *total-effects model* is stylised below.

$$\text{Min} \sum_{i=1}^n (CM_i + CC_i + CE_i)$$

Membership costs (CM) are dynamic in our model, and change with the number of patrons included. The inclusion of one more patron implies an increase in CM and a change in the distribution of resources and outcomes, which lowers the costs of exclusion (CE). At the same time, contractual costs (CC) decrease, since coordination with newly involved patrons stops being the object of contracts (provided that patrons had a contractual relation with the organisation, otherwise CC are unchanged). In order for CE to be zero, contracts should remain in place only with those patrons whose utility is mostly satisfied through the market mechanism.

The decision-making criteria outlined above yields to the condition $CM=CC+CE$. It follows that, in our model, patrons are integrated in the governance of the organisation until $CM<(CC+CE)$. This means that publics are included until CM are lower than the sum of CC and CE , and if CC do not change across governance solutions, when CM are lower than CE (for CC to remain constant, transfers of control rights would have to happen at the same cost for all patrons through an exchange, i.e. a compensation). In this model, the most efficient solution, from both an allocative and distributive point of view, is one for which total costs are the lowest. The model is therefore useful to compare different solutions on the basis of the total level of governance costs generated. Following this construct, Hansmann's model would be a specific solution that can be applied only when CE are disregardable or, in other words, when only one market fails.

5. Discussion

5.1 Deliberation

The total-effect model entails that the inclusion of an additional patron must reduce CE more than it raises CM and CC . This means that a patron must have a considerable advantage in joining the organisation, which can happen only if its interests are acknowledged by the decision making-process more than what contractual solutions can do. On the other hand, CM must not rise uncontrolled. To explain how, on the one hand, CE are reduced and, on the other, CM are kept at bay once membership is enlarged, we need to extend the scope of analysis from

formal structures to processes. This Section discusses the role of binding agreements amongst patrons and deliberative processes.

Consider an organisation with a board of directors where different patrons are represented. Depending on the statute of the organisation, some can be elected among the owners while others can represent non-owners. In the spirit of Meade's discussion of externalities, to reduce CE the board needs to reach a joint participated decision on the strategic direction of the organisation, which managers can then implement. Case studies and experimental results, one for all the work of Ostrom (1990), indicate that shared decisions and binding agreements are the outcome of cooperation among patrons. A precondition to cooperation is identified in communication. These studies show that when individuals can communicate between and among each other, agreements are respected (Sacconi and Faillo, 2010). In addition, experimental results show that cooperative agreements are respected also by those who are not cooperative in the first place. In their work, Grimalda and Sacconi (2005) point out that this happens because, as individuals interact within a cooperative institutional setting, they develop preferences that enable them to respect the agreement. In other words, preferences towards cooperation are shaped by the interaction of actors within an appropriate agreement. Clearly, these findings requires a re-consideration of one of the main arguments in economic theory, that is the inefficiency and instability of collective

decision-making (besides Hansmann see also Olson, 1971/2009; Vidal, 2014; Birchall, 2014).

The aim of reducing CE requires extending membership to interested patrons at the lowest possible CM. The implication of institutional studies for the total-effect model is that when aims are complex and require specialised and complementary investments (as in the case of social service production whereby service continuity is essential) the rise of CM is avoided by binding agreements and non-opportunistic communication between and among patrons.

This form of communication has been discussed as deliberation, especially in the context of democratic and participatory institutions (references). Deliberation would work as a form of substantive involvement which goes beyond the formal engagement entailed in the right to vote in organisational assemblies (which is typical of the ownership relation), or the contractual obligation to deliver a service. Rather, the function of deliberation is to make each and every patron's interest explicit and yet transform it by the cooperative interaction, generating solutions based on argument rather than on power unbalances. These are more likely to be respected and implemented than solutions generated by exclusive processes (Dewey, 1927; Granovetter, 1991; Yeung, 2005; Sacchetti, 2015). Deliberation, in this sense, contributes to lower CE.

Examples of solutions that entail binding agreements (to lower CM) and deliberative processes (to lower CE) are provided by organised transactions

between public administrations and social economy organisations in the co-production of specific community services (Pestoff, 2012; Ostrom, 1996; Sacchetti, 2016).

5.2 Multistakeholder solutions

As discussed, multi-stakeholder organising is a way of governing production where multiple patrons (such as managers, workers, volunteers, users, donors, funders) share strategic control for their common good. It is meant to give voice and to empower patrons in an organisational context, normally designed to produce meritorious goods, such as welfare and community services, including public utilities, but not exclusively. The role of multistakeholder structures has been discussed by scholars who have emphasized its role in the provision of social and welfare services (Pestoff 1994, 1996; Borzaga and Mittone, 1997; Laville and Nyssens, 2001; Sacconi, 2006; Sacchetti and Tortia, 2008; Cafaggi and Iamiceli, 2009).

The distinguishing feature of multi-stakeholder organisations is that patrons with an interest in the activities of the organisation can contribute to decide what and how to produce, or how economic surplus is distributed. Case studies show that multi-stakeholder forms capitalise on the resources of multiple patrons at different levels, by involving them as owners, or by including them in the board of directors or through consultative or controlling committees (Sacchetti and Tortia, 2014; Sacchetti 2016). By sharing decision-making power, this socially

participated form of governance leads to a unique feature, which is that the activities of the organisation are run cooperatively. In this way, the outcomes can benefit multiple patrons, including owners but also non-owners (Borzaga and Mittone, 1997).

The total-effect model can be usefully applied to the study of multi-stakeholder organisational forms. Albeit these are starting to emerge and have been regulated by law in several countries, they are still under theorised. Our model entails that the main reason why it is advantageous to establish an organisation with multi-stakeholder governance is when, in its absence, CE are higher than the CM and CC taken together. Multi-stakeholder governance is therefore desirable only when it minimises total governance costs. This explanation can justify why experiences of social enterprises for which countries (e.g. France, Italy, Spain) have set legal requirements towards the inclusion of multiple patrons have had in general a slow impact on the sector (Galera,). Experiences of multi-stakeholding in fact suggest that, to implement inclusion, major organisational innovations are required, not least to create the conditions for participation, with varying costs attached. Our model, in this case, would suggest that in order for multi-stakeholder solutions to become more widespread, CM must decrease, while excluded patrons should raise awareness of what they miss out by relying solely on market contracting.

5.3 Implications for research

Following from experiences of multi-stakeholder organisations, further research could shed light on the factors that can lower CM and increase a culture of participation. Clarifying these questions could support a better understanding of regulatory requirements. We know, in fact that in specific sectors, such as welfare, the inclusion of more than one patrons can be required by law. But there is a growing amount of experiences, such as across third sector organisations, which evidence that inclusive governance can occur voluntarily prior or instead of regulation, through voluntary multiple membership.

In addition, research can address how organisations with an open approach to patrons can ensure engagement in collective action, how cooperation and preferences towards cooperation are developed, so that agreements are respected and CM are kept under control. This would imply to further research on when patrons are best included via ownership, or via board representation, or both.

In parallel, research can address how exclusion is applied, hypothesising that in a ‘public organisation’ this is limited to the presence of conflicts of interest leading to the effective possibility of opportunistic behaviour.

Another aspect for research is the exploration of democratic practices. While studies have mostly addressed formal participation, we have mentioned that this is not limited to formal voting rules associated with ownership, e.g. one-head-

one-vote. Studying the presence of practices that ensure continued participation and deliberation on relevant decisions and their modalities would add to extant research.

6. Concluding remarks

Hansmann focused on ownership. This paper has argued that there is no reason to assume that important levels of markets and contractual failure exist only for one patron. This can be even more relevant in sectors (such as health, social services, and education) where the complexity of the interests involved can be regarded as an explanation for the emergence of organisational solutions with multiple patrons.

The total-effects model suggests that there are multiple coexisting ways of coordinating economic activities, and that failure to consider exclusion costs is associated with the coordination process in all its possible alternative forms. This means that both market and organised transactions can fail. The argument is that economic organising can be used not only when the costs of transacting are still high once property rights are defined, but also when externalities for the non-owners are high. The total effects model offers a solution and explains that CE can often be effectively reduced by forms of governance that open control and direction to multiple patrons, not necessarily through ownership, but also using other forms of representation in decision-making.

Exclusion costs, in our model, are not a transitory feature of markets or governance solutions, but an intrinsic consequence of the failure of exclusive institutional solutions to identify and address the needs of multiple patrons and society at large. In order to reduce CE, multi-stakeholder solutions have already emerged, though the challenges posed by CM for these organisations require institutional inquiry.

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